DOW THEORY LETTERS INC.

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May 14, DJIA 992.60; PTI 585; A-D Ratio -23.55
May 21, DJIA 990.75; PTI 575; A-D Ratio -23.73

MARKET: The peaks started forming as far back as February, 1976. For the record, I have listed the bull market highs for some of the critical indicators which I follow (and which are discussed here repeatedly).

High	Indicator	Value
February 4	D-J Utility Average	91.90
February 20	Daily New Highs, NYSE	451
February 24	Advance-Decline Ratio NYSE	-21.64
April 5	NYSE Composite Average	55.20
April 5	S & P 500 Average	103.51
April 21	D-J Industrial Average	1011.02
April 22	D-J 40 Bond Average	73.60
May 10	Primary Trend Index (PTI)	591
May 11	D-J Transportation Average	220.91
May 11	D-J 65 Stock Average	310.12
May 12	Cumulative Most-Active Stock Index	-692

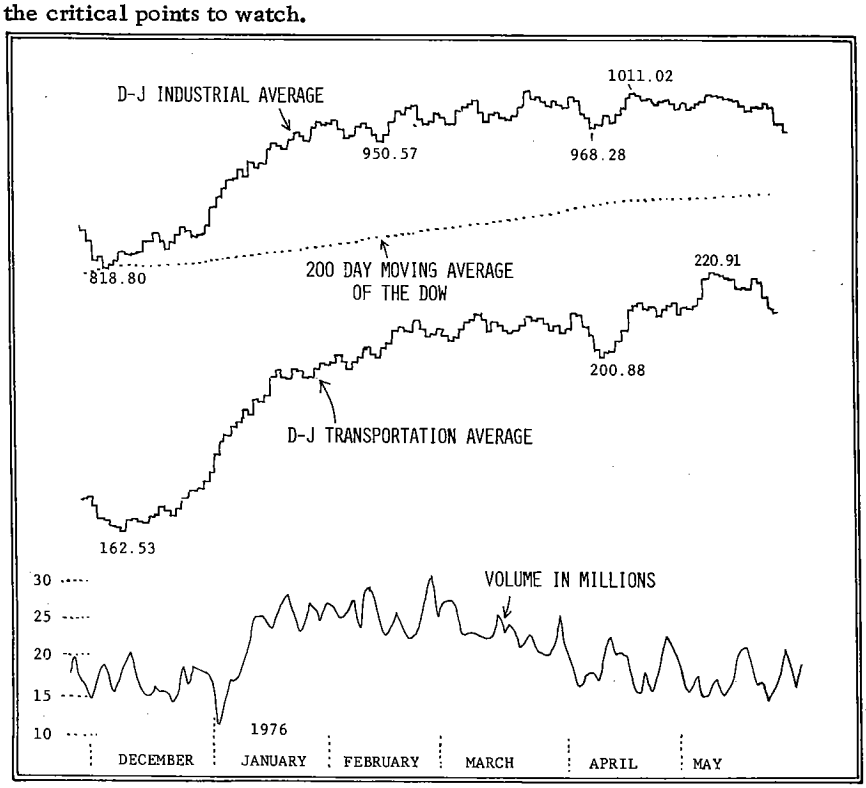
That's the top-out parade, but not all is utter blackness. Almost four months have now elapsed since the long list of 1976 peaks began—and no irreparable damage has yet been done. The fact is that none of the above indicators or Averages are terribly far from their 1976 bull market peaks, with the single exception of the daily new highs. And since new highs tend to be a lagging indicator, I do not attach any particular bearish significance to the current low level of daily new highs on the NYSE.

"All right, Russell," you say, "but I can read the charts and figures as well as the next guy. What I want to know is what do you really think of this market right now?" And my answer is this: we're still in the deceptive, extended second phase of this primary bull market. It's a tough devil, as second phases usually are, and therefore I prefer to stick to the time-tested Dow Theory adage which states that the benefit of the doubt should always be given to the prevailing primary trend (which now happens to be bullish).

"Look, genius," you snap, "never mind the primary trend. It's the secondary trend that's worrying the hell out of me." All right, I'll give you everything I'm thinking regarding the secondary trend. From the Dow Theory standpoint, the Industrial and Transportation Averages have been in "line formations" ever since late-January. The Industrial line limits are 1011.01 and 968.28. The Transport line limits are 220.91 and 200.88. Those are the critical points to watch.

On May 11 the Transports bettered their previous upper line limit, advancing to 220.91. Industrials (see chart at right) refused to follow, and we therefore had an upside confirmation. Having failed on the upside, the market (as so often is the case) had a try for the downside. I had rather expected this, and in the last Letter (page 3) I wrote, "As this is written weakness is again hitting the market, and here it will be most interesting to note whether the Transports will retain their superior relative strength. If they do (and I think they will), then we could get a decline with the Dow perhaps breaking below the lower line limits (below 968.28) with the Transports refusing to confirm. Such action could set the stage for a 'downside fooler,' and perhaps a final windup to the 1976 frustration."

Following the last mailing, market weakness continued, and on Monday, May 24 the South winds blew. The Dow fell over 19 points to 971.53, just 3 points above the important 968.22 level. On the same day Transports closed at 214.70,



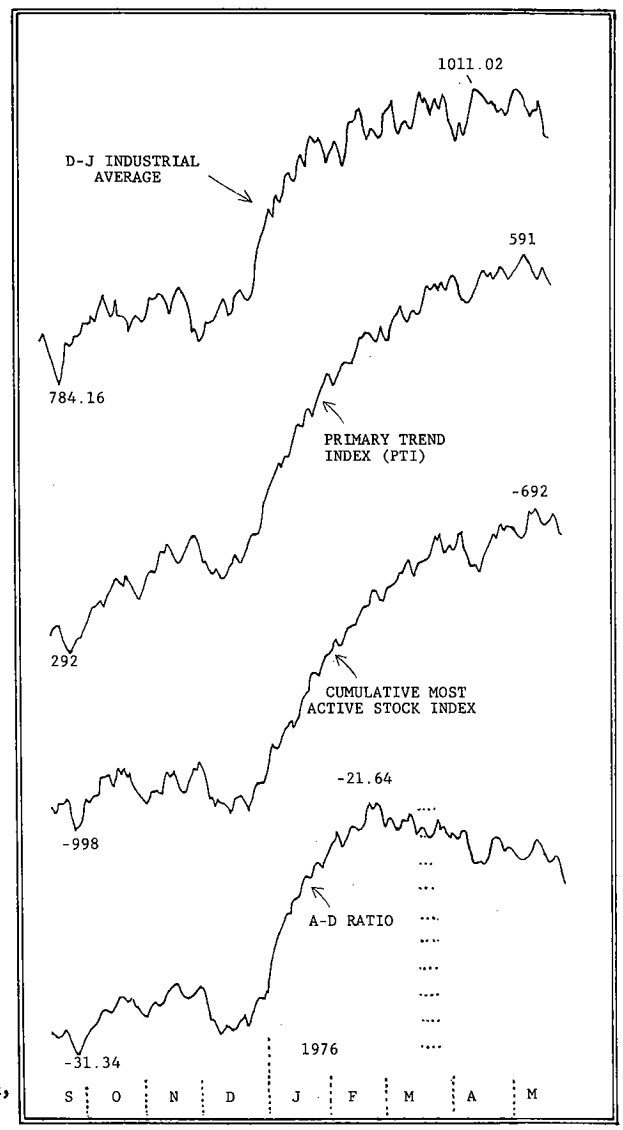
still 14 points over their comparable April low (see page 1 chart). It appears that the Averages mean to give the low points the full test, and if the Industrials close below 968.28 with Transports holding, we will have a good opportunity to gauge the true strength (or weakness) of the price structure.

A persistent Transports nonconfirmation (following an Industrial breaking of 968.28) would set the stage for a good reversal, and another rise back into the line area (and perhaps above it). What happens, you ask, if first Industrials and then Transports drop below the lower line limits (Transports below 200.88)? My answer here is that we will then be in a full secondary reaction, with the next stop a probable Dow testing of its 200 day moving average (the moving average now stands at 900).

Although I always give precedence to the Averages and the price movement, two additional factors rather disturb me at this time. The first are the odd lots. On May 21 (Friday) and May 24 (Monday) the odd lot ratio of purchases to sales dropped below 200. This was the first dip below 200 in many months. That action means that the public decreased its selling or bearishness as the market declined. This is not a healthy development, and if the odd lot ratios continue to sink below the 200 level (i.e., 200 shares sold for every 100 purchased), I am afraid that weakness could continue until the odd lotter grows frightened again and shows it by stepping up his selling. (For the latest comments on the market, see page 6.)

The second element of concern is the pattern of the D-J Utility and D-J 40 Bond Averages. The Bonds are now trending down on a short-term basis although they have not nearly broken their main trend from the 1974 lows. The Utilities have just broken that 1974-76 trend, and on May 24 the Utility Average broke to a four-month low. This could be a result of the current total obsession with money rates, but be that as it may, Utilities have broken their trend. With the main bond trend still intact, however, I rate these two indicators mildly bearish (veteran readers know that I always place a lot of emphasis on the joint trend of these two money-oriented Averages).

I want to review some of the more important indicators at this time. Referring to the accompanying chart, the Primary Trend Index (PTI) which is my own amalgam of 8 critical indicators, is finally looking a bit toppy. Nevertheless, it has not broken down yet. In the six years that I have been computing the PTI, I have never seen it diverge so markedly from the A-D Ratio. The superior strength of the PTI is telling us that the market has been showing great resistance to decline. The balance of technical indicators have held intact remarkably well so far.



The Cumulative Most Active Stock Index (CMAS), which is simply an A-D index of the 15 most actively traded stocks (daily) has also been acting considerably better than the broad NYSE A-D ratio. This indicates that the activity in the most actives has been well on the buy side, despite weakness in the majority of NYSE issues.

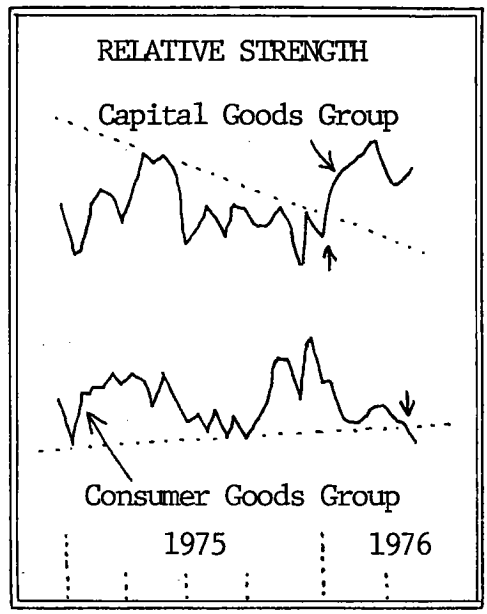
As for the A-D ratio itself, the decline since the February 24 peak has been shallow. Between February 24 and last week, the A-D ratio has lost only 3.00 points. But as seen on the A-D ratio, the corrective action has been persistent in the market. And in terms of A-D action and the majority of stocks, the corrective action has been going on for over three months. This is the longest corrective movement (so far) of the bull market. For instance, the 1975 correction lasted only two months.

I want to remind subscribers again about the page 2 study in the last Letter. That study of the angle of ascent in the Dow indicated that the market must "waste time" or correct or move sideways. It must do one of these things in order to decrease the steep angle of rise in the Dow. I feel that despite all todays news and despite the complicated and esoteric explanations now being offered for the market's stubborn action, the overriding problem is that the bull market went up too rapidly. Wall Street simply ate too much dinner and drank too much champagne, and now we're sweating out a case of extended indigestion.

Now here's an area that interests me at this time. In recent reports I stated that Capital Goods Groups (on a relative strength basis) were outperforming Consumer Goods. In the last Letter I noted that the Foods, the Food Chains, Motion Pictures, Publishing, Hotel-Motel Chains, all those groups were turning down in relative strength (RS). I asked the simple question, "Why?" I don't have THE answer, but the consumer, following his initial relief at finding that North America was not sliding into the sea via the bear market, undoubtedly loosened his purse strings and began buying in earnest. We see it in auto sales statistics, and less spectacularly in retail sales in general.

Now the consumer seems to be sobering up again. Maybe he's suffering from post-Watergate shock, maybe Jimmy Carter's smile is upsetting him, maybe Jerry Brown's Zen asceticism is scaring him, I don't know. All I

do know is that my RS chart of Consumer Groups and Capital Goods Groups is saying that we're sinking to new lows in the Consumer sector while Capital Goods looks more promising. Is Joe America not only dumping his mutual funds and odd lots but cutting back on his trips to MacDonalds and May Co.? It looks that way, at least for the time being.



At this time I want to issue a note of encouragement. It may sound mystical, pseudo-prophetic or perhaps even quackish. Here it is: this IS still a primary bull market, the long-term trend of business and economy is up. And despite interruptions, confusing elections, famines, crop shortages, earthquakes, the swine flu, and warnings from Hubert Humphrey, we will ultimately see a period when the sun is out in full. It will be a period when Washington will seem to have a grip on things, politicians will act as if they can be trusted again, the garbage will be cleaned up on Broadway and another New Era will be "just around the corner." They call that the third phase of a bull market. Alas, we're not there yet, but it will happen, it will .....

TWO CAMPS: The nation is now divided into two camps. The first camp wants to get the Government off its back. The second camp wants to keep its hands in the Government's pockets. It's a situation which is becoming progressively more acute and actually more explosive.

The fact is that the first group (through its tax payments and through its bond-buying ability) is supporting the Government. And the second group is essentially being supported by the Government. Every other man, woman and child in the United States is now receiving some kind of Government payout, which is another way of saying that one half the nation supports the other half, at least to some extent. It's a situation which is building resentment, inefficiencies, exasperation and smouldering anger. It's a situation which must change—or this form of Government will change.

I have never in all the years I have been watching this phenomenon, felt as strongly about it as I do now. Now make no mistake about it. I'm not one of those red-eyed arch conservatives who growls, "Let 'em rot in the street if they won't work." The fact is that I have an autistic daughter who may one day have to be taken care of by the great State of California or by the US Government. So I'm not against legitimate, vital Government aid. And I don't believe in the lame, the halt and the blind starving in the gutters as they used to do, and I don't believe in a Government that stands by while its citizens get shot down in the street by criminals, revolutionaries or soldiers from a foreign country.

But the current situation is totally ridiculous, and it IS NOT WORKING. The unspoken slogan of every individual and agency in the US Government today is "self-perpetuation." And the way Government agencies and workers perpetuate themselves is to grab more power, make new rulings, extend their policing or spending activities, and then ask for more funds so they can "keep the whole thing rolling." Besides practically bankrupting the nation, this absurd process has produced an outlandish and never-ending blizzard of forms, questionnaires, papers and official gobbledygook which amounts to harrassment of the nation's citizens and businesses. And while the cost of all this nonsense continues to rise, the real return to the citizen or to business continues to diminish.

I feel we are nearing the crossroads. Consciously or unconsciously, the Presidential candidates from both parties (all except Humphrey) know it. Ford is talking "less Government" and Reagan has always talked it. The market would accept either of these two men, yet the market is worried.

Business likes Ford, if only because Ford is a safe, "hands-off," caretaker President. And business wants desperately to be left alone. Reagan is also acceptable to business, but Reagan can't win the big one. On the Democratic side, Carter claims he has a pipeline to God, but the trouble is that no one knows where Carter's head is on the actual issues. Humphrey is just another Democratic "free lunch" candidate, and Wall Street views him as a disaster. All of which leaves the market hoping for Ford,but the market is rather nervous about this inarticulate and unexciting incumbent's chances.

What the market is most afraid of it what is not being openly talked about. Let's look at it this way. The real party Democrats (and don't underestimate their power) would rather lose with Humphrey than win with that maverick unknown quantity, Jimmy Carter. Now suppose, just suppose, that "the boys" succeed in dumping Carter, and they come up with old Hubert as their candidate (perhaps throwing in Jerry Brown as a Vice-President "sweetener"). If that happened, and if good old bumbling Gerry Ford did lose to say a Humphrey-Brown ticket....well, Wall Street doesn't even want to think about that one.

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People write me constantly wanting to know how to "protect themselves" against the unknown future, the frightening future. There is a sense of uneasiness pervading the country, a feeling of "when's it going to happen?" and "can I survive?" And of course you can't fool all the people all the time. My readers and most thinking people know that this nation cannot continue building astronomical debt, they know that inflation can't go on forever, they know that you can't run a welfare state and a defense state all in one monster package, and they know what New York City's trouble means and Detroit's trouble and on and on.

Study the chart of money velocity in this report. It is clear that these velocities are in an exponential ascent (i.e., rising toward infinity). At some point ahead these velocity cycles are going to "blow their tops." That point (and I don't know where the final peak will be) will mark the end of the supercycle, a supercycle of rising velocities which began near the 1932 lows. From the ultimate velocity highs (and during the next primary bear market) I expect to see monumental changes in our society, changes which will be political, social and economic.

The changes I foresee will be the most sweeping in modern history. They may entail the fall of the currency, changes in value standards, and broad changes in living standards. For a while "things" may be more valuable than traditional money. Gold may or may not be the only real money, but I would certainly want to own a good portion of gold coins. I would want to own (if possible) my own house, free and clear of debt. I would want to have a number of "hideable" but negotiable items of value such as 19th century US postage stamps or rare autographs or works of art of obvious value.

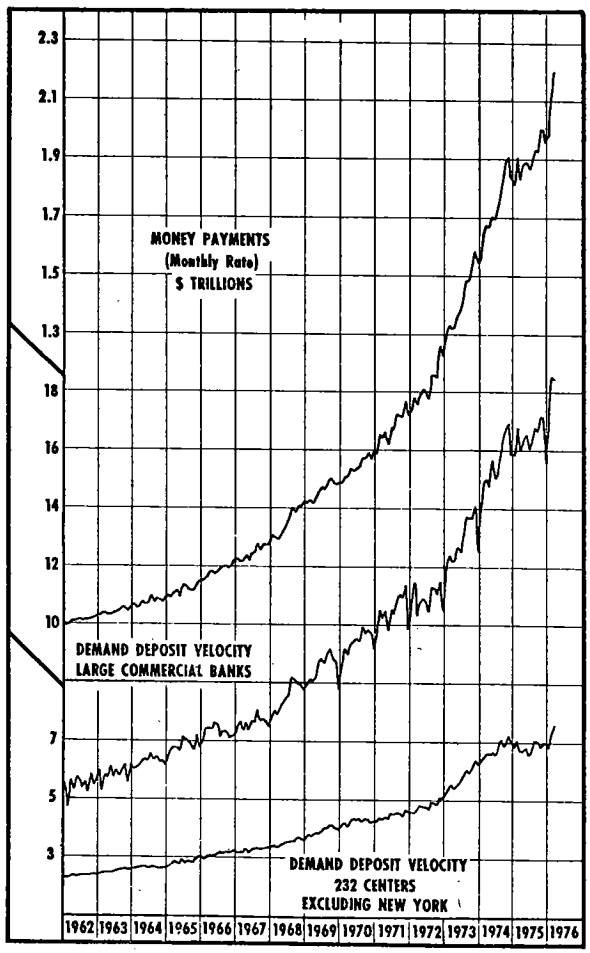
The changes which I think are coming may be so drastic that none of the above will provide "the answer" or even a part of the answer to survival. If so, there is only one thing that the citizen cannot lose, and that one thing is himself, his relationship to himself, and his relationship to God (if you happen to be religious).

My own feeling is that this age of Aquarius is going to put major emphasis on the inner man, the psyche and the spirit. The "new age" may well be ushered in by a collapse in materialism as we know it. Again, I'll say that I don't have any final answer to what I believe is coming up, but intuitively I feel that each of us must now move towards realizing his own potential (it has been estimated that the average person uses only 5% to 10% of his potential while the genius uses perhaps 15% or slightly more of his potential). At any rate, all this is the reason why I insert my constant little pieces about such things as anger, integrating oneself, revealing what is on our minds, not "giving ourselves away," etc. It all seems to boil down to a single word, potential. Just as "all roads lead to Rome," all honest searching leads to one's ultimate potential. And everyone moving towards his own true potential, in my opinion, is the single and only hope for this world.

The great psychiatrist, Carl Jung, may have said it all when he wrote, "Your only duty on this earth is to find yourself—and live accordingly." And the philosopher, Frederick Nietsche, probably discovered the way when he wrote, "That which does not kill me makes me stronger."

BUSINESS, THE CONSUMER & MONEY: My comments about the downturn in the Food, Restaurant and Hotel-Motel stock groups seemed to have touched off a lot of interest and worries among subscribers. No one has the answer to why. I have been told that there is a bill pending in Congress which would give a good deal of new power to franchisees, and that this could hurt franchisors such as MacDonalds. We know that there is a "food war" in Southern California and other parts of the country, and this is hitting supermarkets.

Is the American consumer about to go on strike? Are all those new cars that people are buying going to just sit in front of the house, perhaps to be simonized each Saturday morning and then simply admired for the remainder of the week? My own guess is that people are just not terribly enthusiastic—yet. They are certainly not ready to go on a massive spending binge, and neither are American corporations.



But wait a moment. That's not necessarily bearish. It is conservative, and it's telling us that this economic upturn is going to be prolonged, extended, stretched out, just the way the bull market is now being stretched out via sideways and corrective movements. All of us old, grizzled market veterans have grown so used to the big swings of the 1960's and early '70's that now, with the market, the consumer and business "taking it easy," we are ready to throw in the sponge on the whole thing. I say, let's exercise a little patience.

This chart by Bill Bretz of the Drew Odd Lot Studies (1915 NE 45 St., Fort Lauderdale, FL 33038) shows that all is not as slow or as "bad" as we think it is. The upper line shows total money (demand deposits) turnover at NYC and throughout the nation, and it is still heading strongly up. In fact, the latest figures (shown on chart) indicate an $80 billion rise in payments during March.

The lower two lines simply break up the payment story into the large commercial banks in NYC (second line) and the 232 centers outside of NYC. It is obvious that the action has come evenly across the nation rather than from NYC. This is bullish in that NYC is heavily weighted by financial transactions, while the 232 centers provide a much more accurate picture of what is actually happening in the country.

STOCKS & VALUES: Many so-called technicians become so steeped in the technical approach that they forget that the technical studies are merely our feeble attempts to uncover what the big (informed) money is doing. And the big money deals with fundamentals and values. It buys when it

believes that stocks are great values, and it sells when it thinks those stocks are poor values.

At a price, big money will buy almost anything. If big money thinks bonds are undervalued, it will buy bonds. If it thinks impressionist art is cheap, it will buy it. If it thinks gold is on the bargain table, it will buy gold. If farm land is below value, then it will accumulate farm land.

My friend Fred Whitmore here in San Diego is an excellent student of values. In fact, Fred founded Investment Quality Trends, a stock market service here in La Jolla (5453 La Jolla Blvd., La Jolla, CA 92038), a service which deals in stock values as gauged by dividends and yields. A few months ago Whitmore wrote a piece in which he noted that of three groups which he has watched, the low-priced stocks with high appreciation possibilities have performed best in terms of percentage appreciation.

Here are his rules for picking his low-priced winners. (1) Each had an "A" rating in Standard & Poor's. (2) Each had uninterrupted dividends for at least 25 years. (3) Each had a positive history of increasing dividends. (4) Each sold at a current price which allowed for a 75% to 100% increase on the upside. (5) Latest earnings in each was headed up. And (6) Price/Earnings ratios were relatively low, indicating that the stocks represented good values.

I have been watching a list of Whitmore's selections through this "line" consolidation and correction of the past few months. Most of the stocks are now well down from their highs. Stocks on the list which still qualify are McGraw Hill, Lucky Stores, Lane Bryant, Gulf Life Holding, Delmarva Power & Light, and American Sterilizer.

I have a few further thoughts on values, and this might be a good time to put down a few of those thoughts. The market may now be changing in a very fundamental way. The institutions (which account for about 70% of today's NYSE trading) have become progressively disenchanted with the so-called glamour stocks. With the new fiduciary laws, with the current high interest rates, with today's fat yields on hundreds of good stocks, it is finally dawning on the nation's money managers that "growth" (if it occurs) and dividends tomorrow may not be as prudent as fat dividends and yields today.

The result has been disillusionment with many of the growth and glamour stocks (and a number of them have lost their growth and glamour characteristics), and a general move out of those stocks and in to solid, high-yielding, undervalued stocks. Thus, the market has been a bit shocked as such stocks as Xerox flirt with their lows while stocks like Ford and GM come out with record first quarter earnings. This whole process of glamour bailout and value accumulation is, to my mind, a healthy one. But it is also a drastic one, and one which has been upsetting the market.

Most of the brokers on Wall Street today have never had to deal in a market which wants values, a market which is accumulating high yielding bonds, undervalued stocks. These brokers have grown up in markets which smirked when you talked about dividends or coupons, and suddenly the nation's money managers have become income conscious, and they are thumbing through their compound interest rate tables and wondering where they've been and what they've been thinking over the past decade.

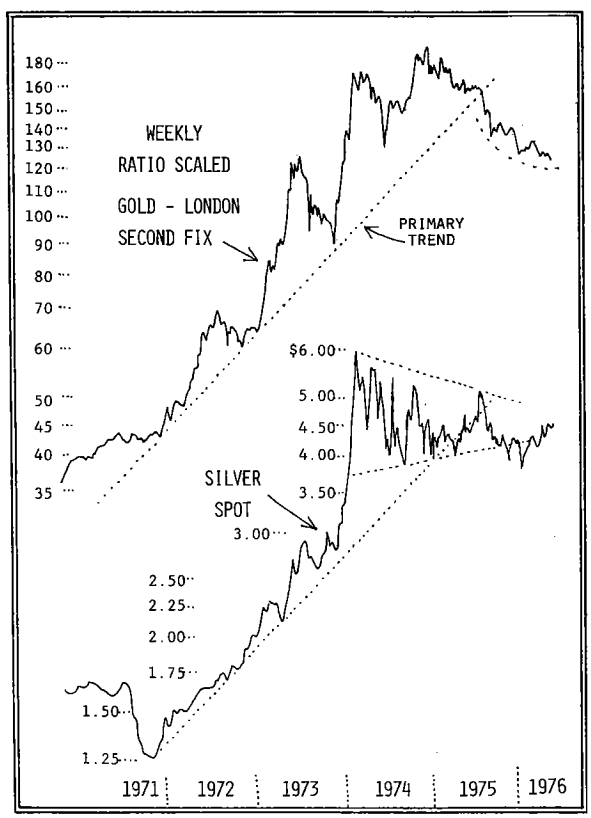
GOLD: By now everyone knows about the coming IMF gold auctions, the first to be scheduled for June 2. Bullion, having "panicked down" to the January, 1976 low of 124.60, followed the typical post-panic script perfectly. After the January panic low, bullion rallied to about 135, then began a slow descent to test the panic lows again. On May 25 the second London gold fix was 124.50, 10¢ below the old low. No new supply appeared, and May 26 saw bullion jump over 125 again. Following a panic low it is characteristic for the price movement to rally, then come down and test and often temporarily break the old low. That may be exactly what occurred on May 25.

If no further supply comes out in this area, then I suspect this is about the bottom. If so, the price action for gold should be dull here, with the next advance being deceptively listless and "grinding."

On the accompanying semi-log chart I have drawn a half-arc which serves to show the subtle deceleration of the gold decline and the potential "rounding bottom." If my rounding bottom analysis is correct, gold should not break 120 on any further weakness. Breaking 120 would tell me that the gold bear market is resuming. Personally, I would be very surprised if 120 is violated.

There's much hope for silver these days, and the chart violation of the huge silver triangle was very temporary. Silver seems to have a good base above 4 dollars, and my chart indicates that a silver rally above 4.80 would break silver out on the upside. If that happens, you can chalk down a big plus for gold as the two seldom go in opposite directions for long.

The gold stocks are acting increasingly "sold out," and my choice would be Dome Mines and Homestake. Both stocks act well, both are gold plays WITH inflation hedges (Dome with oil, Homestake with uranium and other metals).



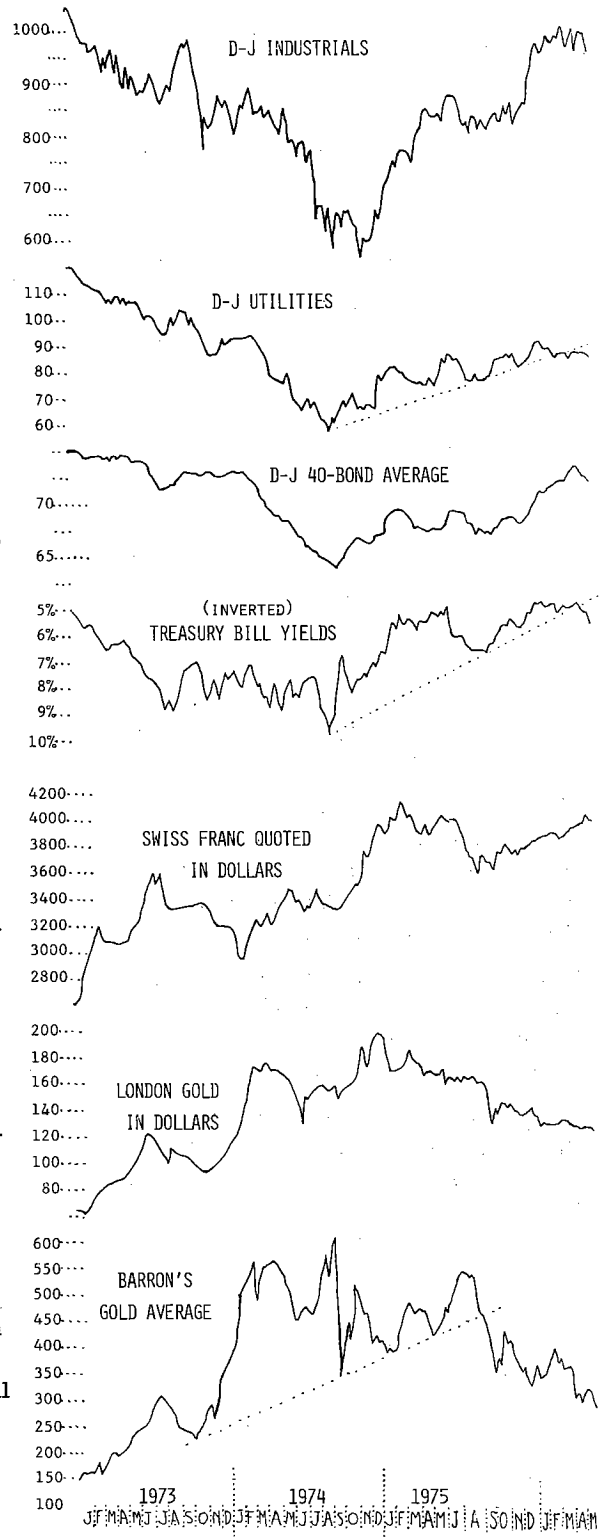
DOLLARS: The US Government may be grinding 'em out like confetti, but the dollar hasn't lost all its value yet. For our purposes, we are not only interested in the continuing purchasing power of the dollar in terms of say steak or potatoes or Chevrolets, we are interested in the comparative value of the dollar against other investments.

This composite chart provides a look at the value of the dollar against some of the alternatives that I watch. For instance, in terms of the high-grade 30 Dow Industrials, it has taken more and more dollars to buy the senior Average ever since late 1974. That's because we've been enjoying a bull market in stocks. Utilities have cost increasing amounts of dollars until recently, but now you see that the trend is towards dollars buying more utilities (as the trendline in utilities is broken). Over the past few months, dollars have also bought more bonds. This twin decline in Bonds and Utilities bothers me a bit, as I stated in an earlier section.

Treasury bill yields have risen in terms of dollars ever since January, and that means that the price of the actual bills has weakened. This, of course, is just the short end of the money market, but it is a very important end. It's scaring investors to death at this time, but I think the terror is unwarranted.

The Swiss franc, which I feel is terribly overvalued, is still a very wanted currency. Its trend in terms of dollars shows us that. But a dollar in the US buys much more than a dollar's worth of francs in Switzerland. Nevertheless, there are many safety minded gentlemen who feel that there's nothing as safe as a Swiss franc. Go argue with them, they've been right for years.

Finally, we have gold and gold shares. The chart says it all here, all but where the end is to the big bear market in gold and gold shares. The bullion decline has been flattening out recently, and that's often a hopeful sign. Not so, Barron's Gold Average, but each bear market has its own way of dying.



LATE NOTES: My two biggest headaches in this business are (1) a stock market which is difficult or extremely deceptive, and (2) a market which is inconclusive just prior to my deadline for writing this report. Currently I have both problems. As this is written, the Industrial Average is just below its April low of 968.28 but Transports are still well above their comparable level. If Industrials close below 968.28, all Dow Theory eyes will turn to the Transports.

This is the way I see it. If Industrials break 968.28 and Transports hold stubbornly above 200.88, we can conclude that a bottom is being formed and that in due time the whole price structure will turn up. However, if the Transports follow Industrials down (by breaking 200.68), particularly on increasing volume, I would take the matter seriously. I would then expect a full secondary reaction. It has been a long time since we have seen a full secondary reaction in a bull market. They can be unnerving affairs. Typically, a bull market reaction may end with a full-scale "selling climax," and that means very high volume at or near the bottom with panic conditions prevailing.

For this reason, IF Industrials break 968.28 and Transports confirm by closing below 200.88 (particularly in higher volume), I would move out of almost all stocks. I say this with one eye on the weakening Bond and Utility Averages as shown on the chart above. And I say it because a full secondary (1) will be very much a possibility if both Averages crack their April lows, (2) because a very good buy spot will appear after the secondary has hit bottom, and (3) because full secondary reactions can be very frightening to ride through, as those of you who were in the market during 1957 or 1962 well remember.

FINAL OBSERVATIONS: So far, Industrials are weakening with Transports tending to hold. The prevailing Wall Street psychology is most interesting, with widespread fears of coming "double digit inflation" accompanied by very high interest rates. The 91-day T-bill futures for June, 1977, are at 8.35%, which means that the Street expects a whopping rise in rates. I remain skeptical of both big inflation and very high interest rates.

NEXT MAILING: June 9th